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PLR-125631-17  
Date:  
February 13, 2018

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Dear :

This letter responds to your letter dated August 18, 2017, and supplemental correspondence, submitted on behalf of Taxpayer and three disregarded entities that are owned directly or indirectly by Taxpayer (hereinafter, collectively referred to as "Taxpayer's Group"), requesting a ruling concerning the federal income tax treatment of consideration paid pursuant to a termination agreement. Specifically, you requested a ruling as to whether D's payment to terminate a sub-license agreement with H is required to be capitalized by Taxpayer for its taxable year ended Date1 under the provisions in section 1.263(a)-4(d)(6)(iii) of the Income Tax Regulations.

## FACTS

Taxpayer is a A limited liability company that is treated as a partnership for federal income tax purposes. Taxpayer was formed in Date2 in connection with a restructuring arrangement. Taxpayer uses an overall accrual method of accounting and uses a calendar year end taxable year. Taxpayer, through its various affiliates, is engaged in the production and marketing of S and related products for I. Taxpayer is owned by three partners: I, J, and K.

The other members of Taxpayer's Group are B, C, and D. B is a A limited liability company that is disregarded entity for federal income tax purposes. B is wholly owned by Taxpayer and was created in connection with the formation of Taxpayer. C is a A limited liability company that is a disregarded entity for federal income tax purposes. C is wholly owned by B. D is a E limited liability company that is a disregarded for federal income tax purposes. D is wholly owned by C.

The intellectual property that is at issue is the name of , E, an individual and the trademarks, image, recognition, and goodwill that are associated with the E name (hereinafter, referred to as the "E name brand"). Ownership or an exclusive license in the E name brand was held by G, a limited liability company that is wholly owned by E. G entered into a licensing agreement with H conveying to H an exclusive sub-license in the rights of the E name brand that were owned by or licensed to G. H is an S corporation that is owned by E and by E's spouse. E and E's spouse have filed joint federal income tax returns for all taxable years in issue.

On Date3, H entered into a development and sub-license agreement (hereinafter, referred to as the "Date3 Sub-License") providing D with certain rights relating to the E name brand and permitting the development of certain S products under the E name brand. D was and is not related to H, G, or E. D manufactures S and related products for T. At the time that the Date3 Sub-License was entered into, D was a partnership that was owned N1 percent by U and N2 percent by V. U was the same entity, prior to a change in its name, that is currently named I. Subsequent to entering into the Date3 Sub-License, I transferred its ownership interest in D to C. V was a partnership in which C held a majority interest. The Date3 Sub-License covered H's rights, as sub-licensee, to use the E name brand in connection with the manufacture, marketing, distribution, and sale of S food and products for T.

In consideration for the grant of the Date3 Sub-License to D, D agreed to pay two separate royalties to H. The first royalty that was payable under the terms of the Date3 Sub-License was an annual amount equal to N3 percent of D's net sales revenue from sales of products covered by the Date3 Sub-License ("sales royalty"). The second royalty that was payable under the terms of the Date3 Sub-License was an annual amount equal to N4 percent of D's net profits derived from D's sales of products covered by the Date3 Sub-License ("profit royalty"). Also, under the Date3 Sub-License, W agreed that F would participate in a designated number of key promotional events each year, subject to reimbursement of F's out-of-pocket expenses associated with such promotion. In addition, D agreed to donate to W designated by H an aggregate annual amount of N5.

The term of the Date3 Sub-License was to expire N6 years after the date of the initial commercial launch of the products covered by the Date3 Sub-License. If, during this initial term, H received at least N7 in aggregate royalties under the Date3 Sub-License, D would be entitled to renew the agreement for an additional N6 years. If, during the initial renewal term, H received at least N8 in aggregate royalties under the Date3 Sub-

License, D would be entitled to renew the agreement for an additional N6 years following the end of the initial renewal term. If the royalties paid to H fell short of the minimum required to renew the agreement, D had the option to pay H the shortfall in order to renew the agreement. The Date3 Sub-License in its original form remained in effect under D's Date4 taxable year.

During D's Date4 taxable year, the Date3 Sub-License was amended on two separate occasions. The first amendment to the Date3 Sub-License was entered on Date5 and amended the Date3 Sub-License in several ways. First, the original renewal options were eliminated, and the term of the Date3 Sub-License extended to Date14, with the possibility of renewal. Second, the intellectual property rights were defined in a more precise manner. Third, the royalty provisions in the Date3 Sub-License were amended so that the N4 percent profit royalty payable to H would be converted into an additional N9 percent sales royalty on D's net sales revenue from products covered by the Date3 Sub-License. Fourth, the N3 percent sales royalty that was payable to H would be payable to a different entity, A1, another limited liability company wholly owned by E and treated as an S-corporation for federal income tax purposes. Finally, D was given the option to discontinue producing and selling products using the E name brand, effective Date15, subject to a transition period.

A second amendment to the Date3 Sub-License was entered on Date6. Under this second amendment, in the event that H licensed a third party to sell any X and Y bearing E's name or image or bearing any of the trademarks subject to the amended Date3 Sub-License in exchange for a royalty, H agreed to pay D N4 percent of any such royalty received by H.

On Date7, following the amendments to the Date3 Sub-License, K acquired an interest in C from I. In Date8, the ownership structures of D and C were modified. As a result, D became wholly owned by C and consequently also became a disregarded entity for federal income tax purposes.

In Date2, the partners in C contributed their ownership interests in C to Taxpayer, a newly formed entity treated as a partnership for federal income tax purposes, in exchange for interests in Taxpayer. In turn, Taxpayer contributed the ownership interests in C to B, a newly formed entity that is a disregarded entity for federal income tax purposes. As a result of the contribution of the interests in C to Taxpayer, C became a disregarded entity for federal income tax purposes, and it retained this status after the contribution of these interests by Taxpayer to B. Taxpayer is treated as a continuation of the C partnership for tax purposes.

On Date9, E and E's spouse, formed a foundation called L, which is described in section 501(c)(3) of the Internal Revenue Code (the Code). The by-laws of L were adopted on Date10. L filed an application with the Internal Revenue Service ("IRS") for recognition of exemption under Section 501(c)(3) of the Code. On Date16, L received a favorable

determination letter from the Internal Revenue Service recognizing L as a tax-exempt entity under section 501(c)(3) from its date of organization.

To implement its goals of increasing its charitable giving and to have a dedicated revenue source for L, E desired to have L, rather than H, become the licensor of the E name brand. Also, the owners of Taxpayer had become concerned that the amended terms of the Date3 Sub-License between H and D, which called for an additional N9 percent sales royalty on certain D product sales and that would become effective Date11, would be a burdensome financial obligation in future years. Accordingly, Taxpayer and representatives of E entered into negotiations to terminate the amended Date3 Sub-License.

The Date3 Sub-License did not contain any express provisions governing the termination of the agreement. However, in light of expectations as to the amount of royalties that would be owed by D under the agreement starting Date11, Taxpayer was willing to pay a substantial sum to terminate the Date3 Sub-License with H and enter into a new agreement with L.

These negotiations resulted in an agreement ("Termination Agreement"), dated Date10, to terminate the Date3 Sub-License between D and H. In exchange for the termination of the Sub-License, D agreed to pay H a termination fee of N13. The Termination Agreement does not provide that entry into a new agreement with L is a prerequisite to the termination of the Date3 Sub-License.

Taxpayer assumes that subsequent to the termination of the Date3 Sub-License, G's sub-license of the rights to the E name brand to H was terminated as well. Also subsequent to the termination of the Date3 Sub-License, E assigned some portion of the rights to the E name brand to M, a A limited liability company that was, at the time of assignment, wholly owned by E.

On Date10, G and M entered into trademark license agreements with L for no consideration. These trademark license agreements granted L sublicenses in trademarks bearing the names E, N, O, and P, E's image or likeness, and any other trademarks that G or M might thereafter authorize, with respect to S products. The initial terms of these trademark license agreements will expire on Date12. At the expiration of the initial terms of the agreements, the agreements will be automatically renewed annually, unless notice is given by L to terminate the agreements.

On Date10, immediately after the termination of the Date3 Sub-License between H and D, C entered into a new sub-licensing agreement (hereinafter, referred to as the "License and Product Agreement") with L to sub-license the E name, trademarks incorporating the words N, O, P, and other trademarks developed in the future, and E's image for use in connection with the manufacture and sale of certain S products. The License and Product Agreement permits C to sub-license its rights to D. As

consideration for these rights, C agreed to pay an annual royalty to L equal to N3 percent of L's and/or D's net sales of licensed products.

The term of the License and Product Agreement will expire on Date13. However, C may terminate the License and Product Agreement at any time after Date14, after giving N4 days' notice to L. In addition, C may at any time, upon giving written notice to L, elect to terminate the use of the licensed property.

On Date10, C entered into an appearance and promotion agreement (hereinafter, referred to as the "Appearance and Promotion Agreement") with Q (an organization owned by E), under which Q undertook to cause E to perform promotional services, such as appearing in television commercials or photographic opportunities or participating in other promotional-type events, and giving C the right to use various licensed materials, with respect to the products licensed under the License and Product Agreement between C and L. The consideration for these services was the issuance to Q of a profits interest represented by Class B units in Taxpayer.

The term of the Appearance and Promotion Agreement is N10 years for promotional services to be performed by E. The term of C's right to use licensed materials created as a result of the Appearance and Promotion Agreement is coterminous with the term of the License and Product Agreement. However, C has the right to terminate the agreement upon giving N11 days' written notice to Q.

In addition, on Date10, H and C entered into a separate license and fee agreement (hereinafter, referred to as the "License and Fee Agreement") under which H granted C a license to use the trademark R with respect to products licensed under the License and Product Agreement, for purposes of publicizing the charitable aspects of the arrangement between L and C. In addition, if during the term of the License and Fee Agreement, H enters into a license with a third party to produce and sell certain licensed accessories, such as X, Y, and supplies for I (but not Z for I) bearing the trademarks covered by the License and Product Agreement, H agreed to pay C consideration in the amount of N12 percent of H's gross royalties collected from any sales of accessories covered by the agreement. This License and Fee Agreement replaced a similar provision in the Date5 amendment to the Date3 Sub-License that was terminated in Date8. That earlier agreement called for the payment by H of a N4 percent royalty with respect to such third-party sales, but the royalty rate on this category of sales was reduced to N12 percent in this License and Fee Agreement. The term of the License and Fee Agreement lasts until such time as C or D discontinues sales of products that are subject to the royalty provided in the License and Product Agreement between L and C.

## LAW

Section 263(a) of the Code provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made

to increase the value of any property or estate or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-1(d) provides examples of expenditures that are capitalized under section 263, including amounts paid to acquire or create intangibles. See section 1.263(a)-1(d)(3).

Section 1.263(a)-4 provides rules for applying § 263 to amounts paid to acquire or create intangibles. Section 1.263(a)-4(b)(1) provides that except as otherwise provided in section 1.263(a)-4, a taxpayer must capitalize an amount paid to (i) acquire an intangible (see section 1.263(a)-4(c)); (ii) create an intangible described in section 1.263(a)-4(d); (iii) create or enhance a separate and distinct intangible asset within the meaning of section 1.263(a)-4(b)(3); (iv) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) facilitate (as defined in section 1.263(a)-4(e)(1)) the acquisition or creation of an intangible.

Neither sections 1.263(a)-4(b)(1)(i) , (iii), nor (iv) apply to the N3 payment made by D to H under the Termination Agreement. First, D's payment is not an amount paid to H to acquire an intangible from H in a purchase or similar transaction as described in section 1.263(a)-4(c). The payment was made primarily to terminate the Date3 Sub-License agreement, and was not made to H in a purchase or similar transaction. Second, as of the date of this letter, this payment does not create or enhance a future benefit identified in published guidance. Third, the payment by D to H is not an amount paid to create or enhance a separate and distinct intangible asset as defined in section 1.263(a)-4(b)(3). Section 1.263(a)-4(b)(3)(ii) specifically provides that amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party are treated as amounts that do not create a separate and distinct intangible asset within the meaning of section 1.263(a)-4(b)(i). However, section 1.263(a)-4(b)(3)(ii) provides a cross-reference to sections 1.263(a)-4(d)(2), (6), and (7), which have rules that specifically require capitalization of amounts paid to terminate to create certain new agreements.

Section 1.263(a)-4(d)(1) provides a general rule that a taxpayer must capitalize amounts paid to create an intangible described in section 1.263(a)-4(d). Section 1.263(a)-4(d)(2)(i) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the financial interests enumerated in section 1.263(a)-4(d)(2)(i). Taxpayer does not need to capitalize under section 1.263(a)-4(d)(2)(i) the amounts paid under the Termination Agreement because Taxpayer's Group did not create, originate, enter into, renew, or renegotiate financial interests in connection with the Termination Agreement.

Section 1.263(a)-4(d)(7)(i) provides that a taxpayer must capitalize amounts paid to another party to terminate: (i) a lease of real or tangible personal property between the taxpayer (as lessor) and the other party (as lessee); (ii) an agreement that grants that

party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business; or (iii) an agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party. Taxpayer is not required to capitalize the payments made under the Termination Agreement under this subparagraph because the parties did not terminate an agreement that is listed in section 1.263(a)-4(d)(7)(i).

Section 1.263(a)-4(d)(6) provides rules for capitalization of a payment made by a taxpayer to another party to create, originate, enter into, renew, or renegotiate with that party certain enumerated agreements or covenants. Under sections 1.263(a)-4(d)(6)(i)(A) and (B), these agreements include, in part, an agreement providing the taxpayer the right to use tangible or intangible property or an agreement providing the taxpayer the right to receive services.

Section 1.263(a)-4(d)(6)(iii) provides that a taxpayer is treated as renegotiating an agreement specified under 1.263(a)-4(d)(6)(i) if the terms of the agreement are modified. Section 1.263(a)-4(d)(6)(iii) provides that a taxpayer is also treated as renegotiating an agreement if: (i) the taxpayer enters a new agreement with the same party (or substantially the same parties) to a terminated agreement, (ii) the taxpayer could not cancel the terminated agreement without the consent of the other party or parties, and (iii) the other party or parties would not have consented to the cancellation unless the taxpayer entered into the new agreement. Thus, for purposes of section 1.263(a)-4(d)(6)(iii), a termination payment must be treated as an amount paid to renegotiate an agreement, and therefore capitalized, if taxpayer enters a new agreement of a type specified in section 1.263(a)-4(d)(i) and the three requirements are satisfied. Or, in other words, if one of the above requirements is not satisfied, then the termination payment is not required to be capitalized under section 1.263(a)-4(d)(2).

Accordingly, each of Taxpayer's new agreements must be analyzed to determine whether they meet each of the criteria under section 1.263(a)-4(d)(6)(iii). If they meet all three of these criteria, the new contract is treated as a renegotiation, and any termination costs allocable to the new contract must be capitalized under section 1.263(a)-4(d)(6) as an amount paid to renegotiating a contract.

As discussed in the facts, C entered into three different agreements immediately following the termination of the Date3 Sub-License between H and D: (1) the License and Product Agreement; (2) the Appearance and Promotion Agreement; and (3) the License and Fee Agreement. Taxpayer acknowledges, and this office agrees, that each of these agreements as well as the terminated agreement involve agreements providing the taxpayer with the contracts rights defined under section 1.263(a)-4(d)(6)(i). Specifically, these agreements provide taxpayer with the right to use intangible property, and/or the right to receive services under sections 1.263(a)-4(d)(6)(i)(A) and (B).



In regards to (1) the License and Product Agreement, Taxpayer argues that the first requirement of section 1.263(a)-4(d)(6)(iii) is not met, and as a result, the termination payment would not be considered an amount paid to renegotiate the License and Product Agreement. Specifically, with regard to this agreement, Taxpayer argues that it is not entering a new agreement with the same party or substantially the same parties to the terminated agreement. The License and Product Agreement covers the same subject matter as the terminated Date3 Sub-License as they both relate to the right to use the E name brand by a member of Taxpayer's Group in connection with the manufacture and sale of S products. However, the Date3 Sub-License was entered into with H, whereas the License and Product Agreement was entered into with L. H is a for-profit S-corporation wholly owned by E and E's spouse, whereas L is a tax-exempt entity. As noted, L received a favorable determination letter from the IRS recognizing L as a tax-exempt entity under section 501(c)(3) from its date of organization, a date before the parties entered the new agreement.

In general, an organization described in section 501(c)(3) is not substantially the same as an unrelated for-profit entity because the organization must be organized and operated exclusively for exempt purposes and no part of the net earnings of the organization may inure to the benefit of any private shareholder or individual. See sections 1.501(c)(3)-1(a) – (c). As noted above, L received a determination letter from the IRS recognizing L as a tax-exempt entity under section 501(c)(3), effective prior to the termination of the Date3 Sub-License and prior to L's entrance into the License and Product Agreement with C. Accordingly, for the sole purpose of interpreting the language, "the same party or (substantially the same party)" under section 1.263(a)-4(d)(2)(iii) under these facts, L and H will not be treated as the same or substantially the same party. Therefore, the first criteria of section 1.263(a)-4(d)(6)(iii) is not met, and the License and Product Agreement will not be treated as a renegotiation of the Date3 Sub-License. As such, no portion of the N13 termination payment by C to H is allocable to the License and Product Agreement as a cost of creating or entering into that contract under section 1.263(a)-4(d)(2).

In addition, section 1.263(a)-4(b)(v) provides that a taxpayer must capitalize an amount paid to facilitate (as defined in section 1.263(a)-4(e)(1)) the acquisition or creation of an intangible. Section 1.263(a)-4(e)(1)(i) specifically provides that an amount is paid to facilitate the acquisition or creation of an intangible if the amount is paid in the process of investigating or otherwise pursuing the transaction. Section 1.263(a)-4(e)(1)(ii) provides that an amount paid to terminate (or facilitate the termination) of an existing agreement does not facilitate the acquisition of another agreement under this section, except as provided in section 1.263(a)-4(d)(6)(iii). As discussed above, section 1.263(a)-4(d)(6)(iii) does not apply to the License and Product Agreement. As a result, the termination payment is also not considered an amount paid to facilitate the creation of the License and Product Agreement under section 1.263(a)-4(e).

In regards to (2) the Appearance and Promotion Agreement and (3) the License and Fee Agreement, Taxpayer acknowledges that C has entered into these new

agreements with the same, or substantially the same, parties as the Date3 Sub-License (i.e., Q and H, both entities wholly owned by E, and/or its spouse). Thus, the first requirement of section 1.263(a)-4(d)(6)(iii) is met with respect to these agreements. Taxpayer also acknowledges that the second requirement of this section was met for each of these agreements because, under the terms of the Date3 Sub-License, Taxpayer could not cancel the terminated agreement without the consent of H and E. However, for each of these two contracts, we cannot ascertain whether the third requirement of section 1.263(a)-4(d)(6)(iii), is met. Specifically, under the facts provided, we cannot determine whether the other parties, H or E (on behalf of H), would not have consented to the cancellation of the Date3 Sub-License unless C or any other member of Taxpayer's Group entered into these new agreements. Moreover, because it is a factual determination, we are unable to ascertain what portion, if any, of the N13 termination payment is properly allocable to the Appearance and Promotion Agreement or the License and Fee Agreement. Accordingly, we are unable to rule on these agreements.

## CONCLUSION

Based solely on the facts and representations submitted, we conclude that D's payment to H of N13 to terminate the Date3 Sub-License is not an amount paid for creating or entering the License and Product Agreement between C and L because the new contract is not treated as a renegotiation of the Date3 Sub-License under section 1.263(a)-4(d)(6)(iii). Accordingly, no portion of the N13 termination payment made by D to H is required to be capitalized under the provisions in section 1.263(a)-4(d)(6)(iii) by reason of C's entry into the new License and Product Agreement with L.

Further, we express no opinion as to whether any portion of the N13 termination payment by D to H is an amount paid to create the License and Fee Agreement with H and/or the Appearance and Promotion Agreement with Q under section 1.263(a)-4(d)(6) or whether either of those agreements represent a renegotiation of the Date3 Sub-License under the provisions of section 1.263(a)-4(d)(6)(iii). As discussed above, we believe that with respect to these contracts, these issues must be resolved on the basis of facts that cannot be determined or sufficiently verified in the context of this letter ruling request. Section 6.02 of Rev. Proc. 2018-1, 2018-1 I.R.B. 1, 18, provides that the Service ordinarily does not issue letter rulings or determination letters in certain areas because of the factual nature of the matter involved or for other reasons. Rev. Proc. 2018-3 and Rev. Proc. 2018-7 provide a list of these areas. Section 4.02(1) of Rev. Proc. 2018-3, I.R.B. 130, 141, provides that the Service ordinarily does not issue letter rulings or determination letters in any matter in which the determination requested is primarily one of fact.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this ruling should be attached to Taxpayer's federal tax returns for the tax year(s) affected. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the provisions of the power of attorney currently on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Charlotte Chyr

Charlotte Chyr  
Acting Branch Chief, Branch 1  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

cc: